8. Has the plan "specifically identifie(d) how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and improvements in productivity due to technological change? (Section 13-506.1(b)(5))

The Commission's review of the existing AI price cap plan also requires the Commission to "specifically identif(y) how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and improvements in productivity due to technological change." 220 ILCS 5/13-506.1(b)(5). As noted by Dr. Selwyn, any efficiency gains and cost savings arising out of the regulatory change, to the extent they exist, can only benefit AI ratepayers if they are passed on to them.

Clearly, given the fact that overall annual rate reductions triggered by the price cap formula have been accompanied by increases in rates reclassified as competitive or bundled as new services, and therefore outside of the pricing constraints of the plan, any alleged efficiency gains or cost savings have not benefited AI's captive business and residential customers. Moreover, given the staggering decline in AI's performance in critical categories of service quality, the Company's customers have hardly benefited under the plan. Given the fact that AI now proposes to lower the productivity offset in the price cap formula, which has the effect of reducing any rate decreases that might flow through the formula, customers would have little to look forward to should the Commission adopt AI's proposed modifications to the formula.

9. Has the plan maintained the quality and availability of telecommunications services? (Section 13-506.1(b)(6))

Despite the Commission's good intentions of preserving service quality through the life of the plan by incorporating a penalty mechanism into the price cap formula, both GCI and Staff witnesses concur that the -.25% penalty level has proven to be woefully inadequate as an incentive to the Company to maintain critical components of noncompetitive telephone service quality. The Company's performance in key service quality areas has been, in a word, abysmal. The record is replete with evidence demonstrating a decline in Ameritech Illinois' service quality, first, since the inception of alternative regulation and, more dramatically, since the Ameritech/SBC merger. While available service quality performance data is compiled in GCI Exhibit 2.1 (TerKeurst), the precipitous decline in AI's service quality is highlighted in the following results and trends:

?? Ameritech Illinois' performance in restoring service to customers within 24 hours of a reported outage (i.e., the OOS>24 measure) has declined dramatically. Contrary to Mr. Gebhardt's assertion that Ameritech Illinois' service has not deteriorated under alternative regulation,[21] Ameritech Illinois' rate of failure in correcting out of service situations within 24 hours averaged about 14.1 percent between 1995 and 1998—over twice the average rate of failure in 1990 through 1994.[22]

?? While Ameritech Illinois had reported some progress in 1999 in restoring out of service situations, its OOS>24 performance declined again in 2000, reaching 15.2 percent in August 2000.[23]

?? For the month of September 2000, AI reported an OOS>24 rate of 37%, more than seven times the allowed rate per 83 Ill. Admin. Code Part 730 and the existing plan.[24]

?? The number of lines that were out of service almost doubled between late 1999 and mid-2000.[25]

?? Since early 1999, the average number of days needed to install a new access line (as captured by the POTS Mean Installation Interval measure) has more than doubled for residential customers.[26]

[21] AI Ex. 1.1 at 39-40.

[22] GCI Ex. 2.0 at 10, citing AI response to CUB data request 4.27(b).

[23] Id., citing AI response to CUB data request 4.31.

[24] Staff Ex. 8.0 at 6.

[25] Id., citing NARUC Company Service Quality Reports July 1999 – June 2000.

?? Between December 1999 and June 2000, the speed at which customer calls are answered (as captured by the Average Speed of Answer measure) declined in the residential and repair call centers and the percent of customer calls answered in those call centers (as captured by the % Calls Answered measure) also declined.[27]

?? The average time taken to repair service, whether for all telecommunications service troubles as a whole (as captured by the Mean Time to Repair measure) or for POTS trouble on a stand-alone basis (as captured by the POTS Mean Time to Repair measure) has sharply increased since the SBC/Ameritech merger, with Ameritech Illinois reporting 77.7 hours to repair POTS in September 2000.[28]

?? Ameritech Illinois has failed to keep an increasing percent of its POTS repair appointments (as captured by the POTS Missed Repair Appointments—Company Reasons measure) since 1998, missing 15.5% of its repair appointments in September 2000.[29]

?? Between 1999 and 2000, repair complaints increased by 71 percent, installation complaints increased by 190 percent, and construction and engineering complaints increased by 119 percent.[30]

?? By August 2000, the number of consumer complaints to Ameritech Illinois as tabulated through the executive appeals complaints process increased compared to 1999. Consumer complaint levels increased by 28 percent, 51 percent, 56 percent and 92 percent for maintenance, network, construction, and customer provisioning complaints, respectively.[31]

?? The percent of customers assigning Ameritech Illinois a low score of 0 to 5 (out of 10 points) for service quality in Ameritech Illinois customer surveys increased by 20 percent from January 1999 to August 2000.[32]

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[26] Id., citing AI response to CUB data request 4.12.

[27] Id.at 12, citing AI response to CUB data request 11.8.

[28] Id., citing AI responses to CUB data requests 4.5 and 11.8; NARUC Company Service Quality Reports June 1999-June 2000.

[29] Id., citing AI responses to CUB data request 4.5.

[30] Id. at 12, citing AI response to CUB data request 11.8.

[31] Id.

[32] Id.

?? Variations in state requirements have resulted in discriminatory treatment of Ameritech Illinois customers. Specifically, calls to Ameritech/SBC's collection offices by customers in other states are currently routed ahead of Illinois customer calls to meet other states' service quality standards.[33]

?? Ameritech Illinois' performance in answering calls from residential customers declined significantly between 1997 (the earliest year for which data is available) and mid-1999. The average speed at which Ameritech Illinois answers residential customer calls (as captured by the Average Speed of Answer—Residential Customer Call Centers measure) increased from 38.2 seconds in January 1997 to 413.1 seconds in June 1999. The percent of residential customer calls answered (as captured by the % Calls Answered—Residential Customer Call Centers measure) declined dramatically, from 93.2 percent in January 1997 to 59.5 percent in June 1999.[34]

Another indicator that the Company's service quality performance has declined under the plan can be found in the records of the ICC's Consumer Services Division ("CSD"), as discussed by Staff witness Cynthia Jackson. See Staff Ex. 9.0 at 7-12. The data collected shows that CSD received a steadily increasing number of complaints against AI from 1995 through November, 2000, the last month for which data was available. For example, in 1995, the first year of the plan, CSD received 14 complaints from AI customers regarding unsatisfactory performance of "scheduling or repair", and 20 complaints regarding unsatisfactory installation service. Id. at 10. By 2000, those numbers had grown to 649 and 992 respectively, and excluded the 850 open service complaints that have not been closed and categorized. Id. Ms. Jackson noted that specific complaints for poor performance by service technicians and customer service representatives have also increased. Id. Of course, not all AI customers are aware of the CSD complaint process. As noted by Ms. Jackson, it is not the numbers themselves but

[33] Id. at 13, citing AI response to CUB data request 4.47.

[34] Id. at 11, citing AI response to CUB data request 11.8.

rather the fact that the number of complaints has grown so substantially that is the source of Staff 's concern.

Ameritech Illinois' own data likewise reveals a pattern of serious degradation in critical service quality components. As noted by Ms. Jackson, AI's total complaint numbers fluctuated during 1997, 1998 and 1999, with annual totals of 11,791; 9,675; and 11,708 respectively. During this three-year period, the number of complaints fluctuated between a monthly low of 41 complaints in September, 1998 and a monthly high of 1,354 complaints in June, 1999. However, complaints for the year 2000 through August totaled 9,984, with four months worth of data outstanding. Likewise, the months of May, June, July and August showed a significant increase with complaints reaching 1,250; 1,618; 1,580; and 1,769 respectively. Staff noted that complaint information was not available from the Company for 1995 and 1996. Id. at 12.

In addition, AI's own monthly analysis of installation and OOS>24 complaints received at its Consumer Executive Appeals Office, which handles complaints directly from consumers, the Commission Staff or an SBC/Ameritech senior manager pursuant to ICC Chairman Mathias' September 28, 2000 data request. AI experienced a 5% increase in installation complaints from January, 1997 through December, 1998 and a 92% increase from January, 1999 to August, 2000. Likewise, AI experienced a 7% decrease in OOS>24 complaints from January, 1997 to December, 1998 and a 28% increase from January, 1999 to August, 2000. Id. at 12-13. During the first eight months of 2000, AI's repair and installation complaints increased 71% and 190% respectively. Construction and engineering complaints also increased 119%, with 62% of the network complaints received in June, July and August, 2000. Moreover, records provided by AI for missed installation appointments show an increase in consumer complaints from 166 in 1997 to 1,049 through August, 2000. Id. at 13.

Staff witness Samuel McClerren, an economic analyst in the Engineering Department of the Commission, detailed in testimony his frustration with the Company's service quality performance, particularly with respect to the OOS>24 hours standard. Mr. McClerren noted that the Staff has met with the Company for years to try to resolve the out of service problem, to no avail. He noted that in spite of the Commission's increased attention to the issue, the inclusion of a $30 million penalty in the SBC/Ameritech Merger Order for failing to meet the standard in calendar year 2000, and the Company's promises to the address the problem, AI *reduced* installation and repair technician staffing levels, as shown in Staff Ex. 8.02. Most of these technician headcount reductions occurred from August 1998 through January 2000, a period during which "increases in technician headcount were promised by the Company", according to McClerren. Staff Ex. 8.0 at 5-6.

Notwithstanding Company assertions to the contrary, AI's performance with respect to the installation within 5 days service quality measure has also been below par during the price cap plan, and particularly deficient in recent years. Mr. McClerren testified that the Company's installation performance has been unsatisfactory throughout the term of the plan. The Company averaged more than five days for POTS installations throughout the January 1999 through September 2000 time frame, with the September 2000 time frames averaging more than 10 days. Staff Ex. 8.0 at 10. Ameritech Illinois also reported above-average delays in installation intervals for POTS service between June and August of 1999, between 6.02 days and 6.41 days, when compared with average installation times of 5.86 days over the course of 1999. As noted above, installation intervals increased again during the August 2000 overtime restrictions. Anecdotal evidence provided by AI's customers in a special meeting of the ICC and in complaints to CUB suggests that these numbers are deceivingly low given the fact that they do not capture Ameritech Illinois' performance for installation requests made in advance of a date certain. The anecdotal data regarding installation intervals for those customers suggests that they wait weeks or months for installation of service. GCI Ex. 2.0 at 14.

Despite this deficient record, the Company has avoided any penalty in the installation within 5 days category. This oversight occurred because the Company has applied, and continues to apply, an incorrect definition of installation performance for purposes of calculating the installation within 5 days measure, that effectively masks poor POTS installation performance. Staff Ex. 8.0 at 7. As explained by Staff witness McClerren, Illinois Administrative Code Part 730.540(a) provides the language that is the foundation for this performance benchmark in the AI price cap plan. Regarding installation performance, the Code states:

> The local exchange carrier shall complete 90% of its regular service installations within five working days after the receipt of the application, unless a later date is requested by the applicant.

83 Ill. Admin. Code Part 730.540(a).

As noted by Mr. McClerren, the existing and historical wording for this standard make clear that the measure relates to the installation of network access lines only. Id. at 7-8. In its calculation of the measure, however, the Company incorporates vertical service installations, including Caller ID, Call Waiting, Call Forwarding, Automatic Callback and other vertical services that require no customer-premises visit for installations. Tr. 1814-1815. As admitted by AI witness John Hudzik, because these services are "installed" via computer entry by a customer service representative (Tr. 1814-15), the time work and time involved in such "installations" is negligible compared to that involved in network access line installations. At the same time, the Company excludes the more labor-intensive installation of second and additional lines from the calculation. Tr. 1815. Given the increased sales in vertical services in recent years, the Company's inclusion of these services, and the exclusion of second-line installation orders, in its computation of the installation within 5 days measure allows POTS installation intervals to worsen without fear of penalty because they are masked by other service installations that require minimal time and effort. GCI Ex. 2.0 at 27. No other local exchange carrier contacted by GCI or the Staff calculates the measure in this manner. Staff Ex. 8.0 at 9, GCI Ex. 2.0 at 27. Staff witness McClerren confirmed that if the Company had calculated the measure the correct way (including POTS network access lines only), it would have failed the installation within 5 days benchmark throughout the life of the plan. Staff Ex. 8.0 at 10.

Moreover, the Company's practice in calculating the OOS>24 Hours measure is likewise flawed. For example, AI excludes a large portion of its lines that are out of service over 24 hours by claiming that they result from an "act of God" with no explanation or justification. GCI Ex. 2.0 at 33. Second, it is unclear whether AI inappropriately includes vertical and other services in its calculation of its performance of the OOS>24 measure. Third, the Company stubbornly defends its practice of dividing the number of lines that are OOS>24 hours, excluding those out of service due to an "act of God" or other allowable exclusions, by the sum total of all out of service lines, including those out of service due to an "act of God" and other allowable exclusions. This methodology effectively underreports the percentage of lines that took longer than 24 hours to restore. Fourth, AI appears to interpret the 24 hour measure to exclude weekends and holidays because it identifies the target to be "Target: *0 Business* Days (less than 24 hours)", and excludes weekends and holidays from its calculation of the duration for which a customer is out of service. Id. Such an interpretation of how to calculate performance of the measure contradicts both 83 Ill. Admin. Code Part 730 and the Price Cap Order, which discuss the measure in terms of *hours* and not business days. Id. at 33-34.

Despite all of these service quality failings, AI has continued to cut costs by offering an early retirement package effective November 15, 2000 to management employees, including experienced field, area and general managers overseeing technicians in the field.[35] AI has also limited the amount of overtime each technician was allowed to work on at least two occasions in the last two years. Specifically, overtime restrictions were imposed in June through August of 1999 and again in August of 2000.[36] Both limitations on overtime coincided with sharp increases in the percentage of lines that were out of service for over 24 hours.[37] These actions belie AI witness excuses that the decline in service quality experienced during the plan is the result of unforeseen retirements of experienced network personnel.

[35] GCI Ex. 2.0 at 19, citing AI response to CUB data request 8.15.

[36] Id., citing AI response to CUB data request 4.39.

[37] Id., citing AI response to CUB data request 4.31.

Ameritech Illinois has argued that the marked decline in its OOS>24 performance during August 2000 was not as much a result of the overtime restriction as a result of balancing between repair and installation work.[38] However, installation work experienced near-record delays during August 2000, with residential service and business service being installed in an average of 9.76 and 8.29 days, respectively.[39] Ameritech Illinois also experienced record high reports of customer dissatisfaction with its installation activities in August 2000.[40] Clearly, the Company's excuse hardly explains AI's poor performance when it comes to restoring customer service.

Deficient service quality not only affects AI's current customers, but also those few who have attempted to obtain service through a competitor. For example, most of the carriers attempting to compete with Ameritech Illinois are resellers that purchase the necessary equipment from AI. Accordingly, even those customers who have switched providers may find themselves at the mercy of AI's incompetence.

In sum then, the Company has utterly failed to "maintain the quality and availability of telecommunications services" under the existing price cap plan, as required by Section 13-506.1(b)(6) of the Act. The service quality penalty structure has proved to be grossly inadequate as an incentive for the Company to meet the benchmarks established by the Commission and not permit service quality to deteriorate.

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[38] Id., citing AI response to CUB data request 4.39.

[39] Id., citing AI response to CUB data request 4.12.

[40] Id., citing AI response to CUB data request 11.8.

10. Has the plan unduly or unreasonably prejudiced or disadvantaged any particular customer class, including telecommunications carriers? (Section 13-506.1(b)(7))

Given the Company's skyrocketing earnings, deficient service quality, and propensity to prematurely classify services as competitive and then increase rates for those services, it is fair to say that the AI price cap plan has unduly disadvantaged noncompetitive service customers as a whole. On the retail side of the equation, both residential and business customers have paid rates that are too high. Specifically, residential customers have seen charges for Band C usage climb steadily since the inception of the plan. Business customers have fared even worse, having had basic network access and all usage services reclassified as competitive, with corresponding rate increases, as noted above in this Brief.

In addition, given the Company's exorbitant level of earnings under the price cap plan, it is clear that the price cap formula's insufficient productivity offset and the lack of an earnings sharing mechanism has produced rates that are higher than would have occurred under rate-of-return regulation, all other things being equal.

Finally, competitive carriers likewise have been disadvantaged under alternative regulation, given the failure of any measurable level of competition to develop in the local market, as discussed above.

11. Is the plan "in the public interest" and "a more appropriate form of regulation"? (Section 13-506.1(b)(1), 13-506.1(b)(4))

As aptly noted by Dr. Selwyn, the Company has approached the required demonstration of compliance with the statutory goals in a perfunctory manner. City of Chicago Ex. 1.0 at 52. The Company is long on vague assertions about what has occurred under price cap regulation and short on specifics to demonstrate that the existing alternative regulation plan is superior to rate-of-return regulation. The alleged benefits of alternative regulation – primarily promoting a transition to a competitive telecommunications market and protecting the rates and service quality of captive monopoly customers – have proven largely elusive under the existing AI price cap plan.

As such, in no way can it be concluded that the price cap regulation for Ameritech Illinois has been "in the public interest."

III. GOING-FORWARD PROPOSAL

A. Relative to Existing Components

As noted above, under the existing price cap plan, AI's noncompetitive service rates have been established according to an annually adjusted price cap formula or index that reflects the offsetting impact of inflation and productivity gains on AI operations. The formula also reflects an offset for failed service quality performance and exogenous revenue changes that comply with specific, Commission-developed criteria. The AI price cap formula is set forth as:

> PCI = Gross Domestic Product Price Index (GDPPI) minus 4.3% for a productivity offset, minus 0.25% for each missed service quality benchmark, +/- a possible Commission-approved exogenous change factor.[41]

Despite the record profit levels the Company has enjoyed under the existing price cap plan, AI is proposing several changes to the plan that gut what little consumer benefit has been derived from the plan, ensure that profits for the Company soar and virtually guarantee that the service quality degradation that occurred during the life of the plan continues. As discussed below, these proposed changes should be rejected. Instead, the

[41] An approved exogenous change is calculated as the ratio of the amount of the exogenous change to the total company revenues for the period in which the change occurred. Price Cap Order at Appendix A, p. 5.

Commission should adopt the recommendations of GCI witnesses TerKeurst and Selwyn, whose proposals to correct the nearly seven-year-old plan work to correct the one-sided flow of benefits to AI shareholders that has occurred during the life of the plan. A detailed discussion of the existing and proposed price cap components follows.

1. Inflation Measure

In what can be described as perhaps one of the few areas of agreement among the parties, a consensus exists that a chain-weighted Gross Domestic Product Price Index ("GDPPI"), published by the U.S. Department of Commerce's Bureau of Economic Analysis, is the appropriate measure of economy-wide output price inflation for purposes of a price cap plan. Use of the chain-weighted GDPPI, which provides for changes in the product mix and bases weights for the current year's index on the prior year, would replace the existing fixed weight GDPPI, which inappropriately assumes that the basket of goods and services upon which the index is based remains frozen over time. GCI Ex. 3.0 at 12-13.[42] Should the Commission approve a new price cap plan for the Company, it should incorporate the chain-weighted GDPPI in the price cap index.

2. Productivity Offset

One of the most important elements of a price cap formula in terms of ensuring that benefits of alternative regulation are passed through to consumers is the establishment of an appropriate productivity offset. In a competitive market, firms have the incentive to improve productivity and cut costs in an effort to increase profits. In theory, as competitors adopt similar cost-saving measures over time, competition will pass the benefits of this improved productivity on to customers through lower prices.

[42] The Bureau of Economic Affairs , the government agency responsible for publishing both these price indices, now recommends use of chain-weighted price indices as a more meaningful measure of economy-wide output price inflation. GCI Ex. 3.0 at 13.

Because price cap regimes control *noncompetitive* services, the characteristics of a competitive market must be reflected through the insertion of an X factor or productivity offset. This X factor is the principal means of producing a flow-through of productivity gains in end-user prices. GCI/City (Selwyn Direct) Ex. 3.0 at 6.

In an effort to ensure that AI's ratepayers benefited from alternative regulation, the Commission approved a productivity factor in its 1994 Order that included a 1.3 percent productivity differential[43], a 2.0 percent input price differential[44], and a 1.0 percent consumer productivity dividend[45], for a total productivity offset or X factor of 4.3 percent. Price Cap Order at 40. In this docket, AI proposes to eliminate the consumer productivity dividend of 1.0 percent, thereby decreasing the X factor to 3.3 percent. AI Ex. 3.0 (O'Brien) at 32-33.

The 4.3% productivity factor approved in 1994 has failed to fully capture the actual extent of AI's productivity growth over the life of the plan, thereby permitting the Company to achieve an excessive level of intrastate earnings. That being said, AI's proposal to further reduce the X factor by eliminating the consumer productivity offset should be rejected. As discussed below, the Commission should adopt the same 6.5 percent X factor that the FCC adopted for its interstate services price cap regime in any price cap formula approved in this docket.

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[43] The productivity component of the X factor captures the efficiency with which a firm uses quantities of resources or inputs such as capital, labor and materials to produce products and services. GCI/City Ex. 3.0 at 7.

[44] The input price differential refers to the inflation rate applicable to the prices that the firm pays its suppliers to purchase the inputs required to produce the products and services that it sells to its customers relative to the economy-wide inflation rate. In competitive markets, changes in output prices reflect changes in input prices. Thus, to replicate the results of a competitive market, the X factor must reflect input price changes as distinct from productivity changes. GCI/City Ex. 3.0 at 8.

[45] The consumer productivity dividend represents an advance commitment by regulators and the utility to flow through to consumers a portion of the benefits that will result from adoption of the incentive regulatory mechanism. Id. at 9.

a. Criticisms of the AI TFP studies

All parties agree that a Total Factor Productivity ("TFP") study is an appropriate basis upon which to establish a productivity offset factor, and has been widely used at both the federal and state levels. GCI/City Ex. 3.0 at 8. AI witness Meitzen presented two TFP studies to support the Company's X factor proposal: an updated "Ameritech-Illinois" version of the TFP study that was relied upon by the Commission establishing the existing AI X factor and an AI-adjusted U.S. Telephone Association TFP study that was submitted by the USTA in the FCC's Price Cap Performance Review Remand Proceeding.

For several reasons, AI's TFP studies should be rejected by the Commission for purposes of formulating the X factor in any new price cap plan. First, AI's use of a company-specific basis for calculating TFP is no longer appropriate. As noted by Dr. Selwyn, the FCC's own price cap formula, which applies to AI in the interstate jurisdiction, is based upon *industry* results rather than those for one specific company. Id. at 15. By mixing an industry-wide based X factor in the interstate jurisdiction with a company specific factor in the state jurisdiction, the potential exists for AI to sustain either a windfall gain or windfall loss. This is true because AI could enhance overall company earnings by showing low measured productivity in the jurisdiction where a jurisdiction-specific measure was used and by masking high measured productivity in the jurisdiction in which a total company measure was used. Id. at 29.[46] Second, as

[46] As explained by Dr. Selwyn, suppose that average total company productivity growth is 9% while interstate-only productivity growth is 12%. Assuming a 25/75 interstate/intrastate service split, the resulting intrastate-only productivity growth rate would be 8%. If an X factor equal to total company productivity were to be applied in both jurisdictions, the result would be the average 9% productivity (i.e., .25 x 9% + .75 x 9%). However, if the total company productivity growth rate is applied in the interstate jurisdiction while the lower, state-only productivity growth rate were applied at the state level, the resulting

discussed throughout this Brief, it is apparent that the 4.3% X factor was insufficient to assure that consumers realized their share of efficiency gains that occurred under price cap regulation. Because the Company was required to reduce its rates by only the GDPPI – 4.3%; was permitted to reclassify services as competitive even though no serious competition existed for many of these services; and was allowed to re-bundle noncompetitive services, such as residential usage, and package them as new services not subject to the plan, AI was able to increase its earnings exponentially, to a staggering 43.08% level.[47] The updated Ameritech Illinois TFP study inappropriately relies upon a Company-specific benchmark, and, accordingly, should not be used in forming the X factor. By using industry-wide rather than Company-specific productivity data, AI is given the ability to best its peers rather than simply to best its own performance. GCI/City Ex. 3.0 at 16.

The USTA TFP study is likewise flawed in several ways. First, as noted by Dr. Selwyn the USTA study has never been used by the FCC for purposes of creating an X factor. Id. at 17. Second, AI witness Meitzen calculated the Input Price Differential by taking the US economy-wide input price growth less the LEC input price growth. Mr. Meitzen took the LEC Input Price Growth directly from the USTA study. Dr. Selwyn observed two major problems with the USTA's measurement of local output and its choice of a cost of capital series. First, the USTA model relied upon by AI utilizes deflated revenues to measure local output. Dr. Selwyn noted that this indirect method of measuring local output does not adequately capture actual physical output growth

average X factor would be 8.25% (i.e., .25 x 9% + .75 x 8%). Since the average X factor would be 8.25% while the average productivity growth rate is 9%, the result is a windfall gain for the ILEC equal to its revenue base times .75%. GCI/City Ex. 3.0 at 27.

[47] See GCI/City Ex. 6.2 at 3-4.

because it is based upon prices that are set by regulation and that do not necessarily reflect the change in physical output, such as growth in minutes of use.

An alternative approach to the USTA's indirect method of measuring output by deflated revenues would be the use of physical output measures, such as calls, minutes of use and lines – data that is readily available and more indicative of changes in physical output. Id. at 19-20.

When the FCC calculated the 6.5 percent X factor in 1997, it initially relied upon local calls as a measure of local output. Id. at 20. During the Remand proceeding[48], the FCC Staff revised its local output measurement to reflect Local Dial Equipment Minutes ("DEMs"), which more accurately capture the total impact of the increased Internet usage on LEC output than any one, single measure. Id. at 20.

Another flaw of the USTA study is its use of economy-wide cost of capital data as a proxy for LEC cost of capital, which does not accurately reflect an LEC's cost of capital. Id. Use of this data inappropriately assumes a level of risk for regulated telephone assets similar to the US economy as a whole. There is no evidence in the record or elsewhere that supports the notion that the telephone industry cost of capital will follow year-to-year changes in the US economy's cost of capital. Id. at 21. As noted by Dr. Selwyn, whatever additional risk relative to the pre-competition era that might exist would necessarily be associated with *competitive* rather than monopoly services. Therefore, using an economy-wide cost of capital in the TFP study creates a cross-

[48] The US Court of Appeals for the District of Columbia remanded to the FCC its original decision to adopt a 6.5% X factor, stating that the FCC failed to provide sufficient rationale for its particular selection of an X factor. As such, the Court did not reject the underlying studies or model relied upon, but rather faulted the agency's justification, as set forth in the written decision, for the specific selection of the 6.5% X factor. The FCC has since adopted a settlement proposal agreed to by Ameritech and presented by the Coalition for Affordable Local and Long Distance Service ("CALLS") that utilizes the same 6.5 percent approved by the FCC. GCI Ex. 3.0 at 24-28.

subsidy flow from noncompetitive services, which can be financed at a lower cost of capital, to competitive services, which on a stand-alone basis require a higher cost of capital than the risk-adjusted company-wide average. Id.

In sum then, the Company's proposal of a 3.3% X factor is based on the use of flawed TFP studies, and should be rejected.

b. Use of the FCC-approved 6.5% productivity factor

In order to better ensure that AI's noncompetitive service rates are established at just and reasonable levels under any price cap plan approved in this docket, the Commission should adopt the 6.5% productivity factor that the FCC deemed appropriate for AI, which includes a 0.5% Consumer Productivity Dividend, as an offset in the formula. There are many reasons to support this proposal.

First, the FCC's 6.5 percent X factor is based upon unseparated total company productivity results. Id. at 22. If the Commission were to adopt a different, and lower, X factor for AI, the result would be a windfall gain for the Company. For example, as noted above, AI could enhance overall company earnings by showing low measured productivity in the jurisdiction where a jurisdiction-specific measure was used and by masking high measured productivity in the jurisdiction in which a total company measure was used. Id. at 29. Accordingly, since the cost conditions present in the federal jurisdiction are *by definition* identical and inseparable from those present at the state level, no basis exists for the Commission to adopt anything *less* than the FCC's 6.5 percent X factor. Id. at 22-23.

In addition, the FCC Staff analyzed productivity and input price differentials for the post-divestiture time period from 1986 through 1995, and computed average total company X-factors ranging between 5.1 percent and 6.1 percent, with the result depending on the time period selected for computing the average. Id. at 23. Based in part upon these results and in part upon the inclusion of a consumer productivity dividend ("CPD") of 0.5 percent, the FCC in 1997 adopted the 6.5 percent X factor. Id.

As noted above, after a US District Court of Appeals remanded the FCC decision, faulting the lack of a specific written rationale for the selected productivity factor, a settlement was reached among the parties in lieu of making a specific finding pursuant to the remand. The settlement reached incorporated a 6.5 percent X factor and was supported by Ameritech Illinois. Id. at 25.[49]

As further evidence of the appropriateness of the recommended 6.5 percent X factor, Dr. Selwyn performed an implicit X factor analysis which calculated a productivity factor that, had it been in effect from inception of the price cap plan, would have allowed AI to achieve its allowed return of 11.36 percent. [50] The resulting X factor was 11.06 percent, underscoring the conservative nature of the proposed 6.5 percent X factor. Dr. Selwyn's calculation of the 11.06 percent implicit X factor was based upon *unseparated* AI data and operations results, rather than intrastate-only, jurisdictional results, which is the same approach utilized by the FCC, as discussed above. Id. at 26. The details of Dr. Selwyn's computation of the 11.06 percent implicit X factor are discussed at pages 33-35 of GCI/City Ex. 3.0.

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[49] FCC CC Docket No. 92-262, *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Low-Volume Long Distance Users, Federal-State Joint Board on Universal Service,* CC Docket Nos. 98-262, 94-1, 99-249, 96-45, *Notice of Proposed Rulemaking,* released September 15, 1999, Appendix C, Memorandum in Support of the Coalition for Affordable Local and Long Distance Service Plan."
[50] Price Cap Order at 174.

The implicit X factor analysis illustrates that such a level of productivity is clearly within the realm of possible achievement for AI and that the Company should still be able to reap the rewards of its gains. The implicit X factor analysis also shows that the current 4.3 percent productivity factor has proven to be inadequate, and that rates could have been reduced much more than they have been while still permitting the Company to earn a return on equity well in excess of that which had been authorized. Id. at 36.

c. The essential nature of the Consumer Productivity Dividend

As noted earlier in this Brief, Section 13-506.1(b)(5) requires the Commission to find, before approving an alternative regulatory plan, that the plan "specifically identifies how ratepayers will benefit from any efficiency gains, cost savings arising from regulatory change, and improvements in productivity due to technological change." 220 ILCS 5.13-506.1(b)(5). In 1994, the Commission found that the "most direct and appropriate way to achieve these goals" was to adopt a Consumer Productivity Dividend to "ensure that ratepayers will receive the first cut from any improvements beyond historical performance which arise from technological and regulatory change." Price Cap Order at 179. In doing so, the Commission clearly determined that productivity gains are not reserved solely for the Company.

AI's proposal to eliminate the Consumer Productivity Dividend ("CPD") should be rejected for several reasons. First, the CPD both encourages an incumbent carrier to improve its overall efficiency and recognizes the salutary effects of alternative regulation in stimulating productivity improvements. The CPD also acts as a form of consumer protection in that it helps to ensure that consumers receive at least some of the specific benefits of price cap regulation, even if the productivity level used in the price cap formula is set so low that the LEC retains earnings that are excessively high, as has been the case with Ameritech Illinois. Id. at 10.

Although Dr. Selwyn recommended the adoption of a 1.0 CPD in the original Price Cap proceeding (ICC Docket No. 92-0448/93-0239), his proposal here is that the Commission conform the X factor component to that adopted by the FCC, since the FCC's 6.5 percent X factor was based upon total company productivity results. Id. at 23-24. In other words, the CPD of 0.5 percent is part and parcel of the overall 6.5 percent X factor. Should the Commission adopt an X factor that is below 6.5 percent, Dr. Selwyn recommends that the existing 1.0 percent Illinois CPD be retained and added to whatever productivity/input price differential the Commission deems appropriate. Id. at 24.

* * *

In sum, CUB urges the Commission to reject the Company's proposal to eliminate the CPD, leaving a 3.3 percent productivity factor for any new plan adopted. Instead, the Commission should recognize the failure of the existing 4.3 percent X factor to pass through to ratepayers an equitable share of the savings achieved by the Company during the life of the plan, as evidenced by the Company's excessive overearnings. The Commission should correct this deficiency in the existing plan by adopting an X factor of 6.5%, which incorporates the FCC's 0.5% CPD level. Should the Commission choose an X factor lower than 6.5 percent, a 1.0 percent CPD should be incorporated into the productivity/input price differential it deems appropriate.

3. Exogenous Factor

With respect to the exogenous factor, the Company proposes that the Commission expressly allow exogenous factor treatment to offset ICC-mandated rate changes, and that the offsets occur within 30 days without waiting for the next annual filing. AI Ex. 1.1 at 36-37.

In support of its proposal, AI witness Gebhardt claims that the Commission's application of the price cap factor has been asymmetrical, resulting in only downward adjustments to the PCI. Id. at 35. The Company's arguments and proposal should be rejected, and the existing provision retained, for several reasons.

First, AI's proposal to offset all ICC-mandated rate changes is an invitation for abuse of the factor. When it created the exogenous factor, the Commission limited such treatment to exogenous costs that are truly outside Ameritech Illinois' control and that would not be picked up in the economy-wide inflation factor. Price Cap Order at 62-63. In later annual filing rulings, the Commission further ruled that financial effects of an exogenous change must be verifiable and quantifiable and must exceed $3 million.[51] The Commission determined that these criteria are merely screening factors that must be coupled with consideration of whether rates resulting from the price cap formula would not be just and reasonable without inclusion of the exogenous adjustment.[52] Application of these standards resulted in the Commission's just rejection of AI's requests for exogenous factor treatment in 1995, 1996 and 1997. See GCI Ex. 1.0 at 35-37.

Second, AI's proposal to allow automatic offsets for *all* Commission-mandated rate changes would circumvent the Commission's discretion to determine whether the price regulation formula is just and reasonable absent the offset. Id. at 38. Further, there is no reason to conclude that all Commission-mandated rate changes would meet even the

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[51] Order in ICC Docket 97-0157 at 3.

[52] Order in ICC Docket 95-0182 at 4; Order in ICC Docket 96-0172 at 5.

"screening factor" criteria for exogenous treatment. Using access charge reductions as an example, the demand and, thus, revenue effects of access charge reductions would be very difficult to isolate so they can be quantified and verified. Id. Access charge reductions, accompanied by retail rate reductions, have been a major factor contributing to the substantial demand growth that has occurred in recent years for both intrastate and interstate long distance services. This demand growth, in turn, has offset to some extent the revenue effects of access charge reductions. Further, for both intraLATA and interLATA services, should Ameritech Illinois obtain interLATA authority, demand for access services depends to some extent on the competitiveness of Ameritech Illinois' own long distance offerings, a factor within Ameritech Illinois' control. Id. at 38-39. AI never has asked for exogenous factor treatment of mandated access charge changes either in Illinois or before the FCC, an implicit recognition that such rate changes do not meet either the state or federal criteria for exogenous treatment. Id.

Moreover, as noted by GCI witness TerKeurst, there is a troubling circularity to AI's request. For example, would a Commission-mandated change in the price cap index qualify for exogenous treatment? AI's proposed exogenous factor provision could, in effect, eliminate the Commission's ability to reduce Ameritech Illinois' rates (for noncompetitive and/or competitive services) as required by the PUA upon a finding that rates are not just and reasonable. For example, assuming a downward rate reinitialization is approved in this docket, AI could immediately request exogenous treatment for this ICC-mandated rate change. Automatic exogenous factor treatment would offset a portion of any Commission-mandated rate reductions, with some of the effects possibly flowing back to the very same services whose rates were reduced. Id. at 39.

Aptly characterized by Dr. Selwyn as the classic "Heads I win, tails you lose" scenario, the one-sided nature of AI's proposal would allow the Company to be made whole with respect to rate decreases ordered by the Commission, but would give no effect to increases that the Company has been able to effect as a result of having services classified as "competitive" when in fact effective competition did not exist. City of Chicago Ex. 1.0 at 58. Moreover, to the extent that the proposal would require additional filings with the Commission, it is contrary to the public policy goal of Section 13-506.1(a), which requires that alternative regulation reduce regulatory costs. Id. at 59.

Should the Company ever determine that the price cap plan is not providing a sufficient revenue stream, it is free to utilize the ratemaking provisions of Article IX of the Act, or to file for rescission of any approved plan under Section 13-506.1(e) of the Act.

Finally, as noted by GCI witness TerKeurst, one alternative to compensating the Company for unexpected ICC-ordered rate reductions through an exogenous change factor is through an earnings review such as is being undertaken as part of this review proceeding. Such an earnings review assesses whether rate adjustments are needed as a result of *all* of the many factors that affect Ameritech Illinois' earnings but do not meet the criteria for exogenous factor treatment. Such a procedure ensures that rate re-initialization is even-handed so that Ameritech Illinois' rates remain just and reasonable.

Amazingly, Commission Staff witness Genio Staranczak supports the Company's proposed change to the exogenous factor. Staff Ex. 16 at 4-7. Mr. Staranczak's opinions, however, should be given little weight for a couple of reasons. First, until only recently, Mr. Staranczak has spent nearly his entire career as a Bell Canada employee. During his tenure there, he was primarily responsible for putting together the Company's price cap formula. Staff Ex. 2.0 at 2. It is fair to say that Mr. Staranczak's work experience lends a certain bias to the task of commenting on a Bell company's price cap formula proposals.

Second, Mr. Staranczak never responded to the points raised by Ms. TerKeurst and Dr. Selwyn regarding the Company's ability to seek revenue relief within the context of a review proceeding such as this, or the ratemaking provisions of the PUA. Nor did Mr. Staranczak address Dr. Selwyn's point that the Company's proposal necessarily engenders additional regulatory work and delay, contrary to Section 13-506.1(a)(1).

For all of these reasons, Ameritech Illinois' proposed modifications to the exogenous factor provisions of the price cap mechanism, and Staff's support to the proposal, should be rejected.

4. Pricing Flexibility and Basket Consolidation

Under the existing price cap plan, AI's noncompetitive services are grouped in four baskets: the residential services basket, which includes network access and Band A and B usage; the business services basket, the carrier services basket, and the other services basket, which includes vertical and other non-essential services. The Commission set a cap on basic residential services (network access line and usage) in the last Price Cap Order, while other rates can be increased once within a year by no more than the change in the PCI plus 2 percent. The demand-weighted API for each basket must be maintained at or below the PCI at all times. See Price Cap Order at 64-66, 68-71.

At the beginning of the proceeding, AI proposed to include all noncompetitive services within a single basket and likewise permit up to a 15 percent increase per year for a given service, if offset by price decreases in other services sufficient to preserve the overall price cap index limitation. In rebuttal testimony, the Company revised its position with respect to pricing flexibility, and presented two alternative proposals that depend on whether the Commission approves its rate rebalancing proposal. The first alternative assumes Commission approval of the Company's proposed network access line increases. Under this scenario, annual price increases for individual rate elements would be capped at the change in the PCI plus 5 percent. AI Ex. at . The second alternative assumes Commission rejection of the rate rebalancing proposal, and recommends that the annual price increases for individual rate elements be capped at the change in the PCI plus 10 percent, with increases being allowed to reach a maximum of 30 percent over the next five years. Id. Company witness Thomas O'Brien opines that such changes in the plan would allow most services to be brought to or near cost. Id.

These proposals should be soundly rejected by the Commission for several reasons. First, the Company has presented no evidence that the existing plus-or-minus two percent pricing flexibility has impeded its ability to react to market forces. Likewise, no evidence was presented that the Company had lost any market share for any service as a result of the two percent pricing constraint.

Second, the level of pricing flexibility requested by the Company actually permits AI to modify rates without any specific relationship to cost, contrary to its stated objective to move network access lines (and any other services) closer to cost. City of Chicago Ex. 1.0 at 69-70. In addition, the proposals enable AI to reduce the price of a service that it will subsequently seek to reclassify as "competitive" while raising the price of service that are to remain in the noncompetitive category. After the reclassification, the effective price level applicable to "noncompetitive" services would have increased in excess of the price cap ceiling, due to the fact that the "competitive" service and its corresponding rate change has been removed from the basket. Id. Without any requirement for accountability within the single monopoly services basket, AI could utilize this device to effectively create a permanent source of support flowing from a monopoly service to a subsequently reclassified "competitive". Id. at 70-71.

Moreover, as pointed out by Ms. TerKeurst, a "rebalancing" of AI's rates already has occurred under the current plan, as the declining PCI has produced some reductions in residential business and other basket services, while residential NAL rates have remained the same. Moreover, as Mr. Gebhardt conceded,[53] reductions in the PCI capture the overall efficiency gains achieved by AI in offering service. Given the decline in the PCI while residential network access line rates have remained the same, the residential NAL rates are further above cost than they were at the inception of the price cap plan. GCI Ex. 11.0 at 45.

AI's proposal to consolidate the four baskets into one should likewise be rejected. When the Commission approved the four-basket structure in the Price Cap Order, it correctly recognized that such a structure is needed to help ensure that telecommunications services will be available to all Illinois citizens at just, reasonable, and affordable rates, consistent with the goals identified in the PUA. See, e.g., 220 ILCS 5/13-103(a). As noted by GCI witness TerKeurst, by not allowing AI to unilaterally shift revenues among baskets, this structure helps ensure equitable treatment of *all* customer classes. GCI Ex. 1.0 at 45. The four-basket structure also limits AI's ability to engage in Ramsey pricing (i.e., raising the rates of services for which demand is less elastic while

[53] AI Ex. 1.3 at 85.

reducing rates of services for which demand is more elastic services to maximize profit.) Price Cap Order at 69. Without the four-basket structure, AI would be in a position to unilaterally determine which customer classes would benefit from annual rate reductions, and which customers would be excluded from such benefits and even saddled with rate increases. GCI Ex. 1.0 at 45-46.

In addition, consolidation of the baskets as AI proposes would also increase the incentives for AI to prematurely reclassify services as competitive. As explained by Ms. TerKeurst, AI could raise rates of residential services while reducing rates of services it intends to reclassify as competitive. Once reclassified, the Company could then raise the rates of the reclassified services back to their previous levels (or higher), with shareholders benefiting from the increases in both noncompetitive services and competitive rates. Accordingly, the single-basket methodology would prevent the Commission from easily determining whether the Company is "unduly or unreasonably prejudic[ing] or disadvantag[ing] any particular customer class, including telecommunications carriers" (220 ILCS 5/ 13-506.1(b)(7)) -- a prerequisite for approval of an alternative regulatory plan.

In short, the Company's proposals to eliminate three of the existing four service baskets and significantly expand its ability to increase services within the single noncompetitive service basket work against the goals of fostering competition and ensuring that noncompetitive service rates are just and reasonable. As such, they should be rejected outright by the Commission. Should the Commission choose to adopt alternative regulation again, it should retain the plus-or-minus two percent pricing flexibility in the formula that exists today.

5. Residential Service Rate Cap

There are several reasons why retention of the residential rate cap is in the public interest. First, the conditions that caused the Commission to include the cap in the existing price cap plan in order to ensure that the conditions set forth in Section 13-506.1(b) are met have not changed. Residential NAL and usage service (Bands A and B) remain noncompetitive services subject to negligible competitive threat. By including these services under a rate cap, and making the additional modifications to the formula recommended in this Brief, "the customers whose demands are the most inelastic will be protected from the exercise of monopoly power during the pendency of this plan." See Price Cap Order at 64. When combined with the rate re-initialization and modifications to the formula proposed in this Brief, extension of the residential rate cap will help ensure that rates produced under the plan are "fair, just and reasonable", as required under Section 13-506.1(b)(2) of the Act.

Second, as noted earlier in this Brief, any changes made by the Commission to the existing price cap plan in effect constitute the establishment of a new alternative regulatory plan. This distinction is critical in terms of complying with Section 13-506.1 of the Act. That provision requires that, for the first 3 years the plan is in effect, basic residence service rates must be set no higher than those rates in effect 180 days before the filing of the plan.[54] Unless a residential rate cap is included in the plan, even price changes falling within the existing two percent pricing flexibility factor would constitute illegal increases for basic residence service under 13-506.1(c).

[54] For purposes of this Section, "basic residence service rates" shall mean monthly recurring charges for the telecommunications carrier's lowest priced primary residence network access lines, along with any associated untimed or flat rate local usage charges.

Third, the Commission's concern with satisfying the statutory and policy goal of universal service has not changed in the six years since the price cap plan began. Indeed, the Commission's concern with ensuring that residential service remain affordable for all customers should be heightened, given the decline in universal service Illinois has experienced during the life of the price cap plan. See GCI Ex. 8.0 (Dunkel Direct) at 6-11. The Commission's recognition of the "general principle of microeconomics that customers with inelastic demands have access to fewer substitute products" still applies today. Id. The principles of universal service embedded in the PUA (see, e.g., Section 13-103(a), 13-506.1(a)) must be applied to the Commission's consideration of which regulatory plan to adopt in this docket. When it issued the 1994 Price Cap Order, the Commission noted:

> With respect to the price/cost disparity, we agree that it is unfortunate that some disparity also will be frozen in place, but we believe that the preservation of universal service represents a matter of public interest that overrides rigid adherence to pure cost-based pricing.

Price Cap Order at 65-66. Again, these observations remain as salient, if not more relevant, today as they did in 1994.

AI witness Harris, however, not only opposes any extension of the cap, but argues that residential rate increases would address alleged subsidies other services have provided to residential services, and would allow competition to grow vigorously in the residential market. AI Ex. 4.2 at 20-21. Dr. Harris' flippant viewpoint is not persuasive.

First, as noted by Mr. Dunkel's detailed study of the Company's cost of service studies, the current residential NAL rates are well above their long run service incremental cost ("LRSIC"). GCI Ex. 8.0 at 11-13. Accordingly, the alleged subsidy of residential NAL service is illusory. Second, the protection of captive ratepayers is a central mandate of alternative regulation under the statute. Promoting "competition" that results in higher prices for residential customers is not. Certainly, the General Assembly would have something to say in response to a Commission Order that endorsed Dr. Harris' "competition at all costs" viewpoint.

For all of the reasons stated above, the Commission should extend the residential rate cap in any alternative regulatory plan adopted in this proceeding.

6. Exclusion of Certain Noncompetitive Services From Alternative Regulation

Ameritech Illinois is proposing exclusion of four noncompetitive services from the any new alternative regulation plan: (1) switched and nonswitched access services, (2) UNEs, interconnection, and transport and termination services, (3) wholesale services, and (4) emergency services. AI Ex. 3.0 at 14-15. This recommendation should be excluded for several reasons. First, Section 13-506.1 does not authorize complete exclusion of a subset of noncompetitive services from alternative regulation. Even if the Act could be interpreted to permit such a scheme, there are reasons each of the services listed above should not be excluded from the plan, as discussed further below.

In addition, excluding services from the price cap mechanism would mean smaller revenue reductions than would otherwise occur if the PCI decreases. GCI Ex. 1.0 at 48. The price cap formula is meant to estimate indirectly the amount by which costs for *all* services, including all noncompetitive services, change over time. Id. at 48-49. In the first Price Cap proceeding, AI proposed to exclude basic residential services, which were subject to a statutory rate cap, from the residential basket. With the expectation that the PCI could decrease, Staff opposed that proposal, pointing out that excluding basic residential rates from the residential basket would preclude rate decreases that properly should be made, and the Commission agreed. Price Cap Order at 68-69. The same situation could occur if the Company's current proposal is approved. While cost studies may not be performed annually to update rates for access services, for example, AI's costs would change over time, and inclusion in the price cap mechanism of such services would allow those cost changes to be reflected in rates more quickly than would be practical if cost studies were required. GCI Ex. 1.0 at 49.

Second, and equally important, if the service quality incentive provisions remain within the price cap mechanism through the service quality index, removal of some noncompetitive services from the price cap mechanism would reduce the magnitude of the service quality incentive for Ameritech Illinois to maintain its quality of service consistent with the adopted standards. Id. Of course, administration of the service quality incentive mechanism separate from the price cap mechanism, as CUB recommends, would remove this concern since the financial consequences of not meeting the service quality standards would be independent of the amount of noncompetitive revenues in the price cap mechanism.

Generally, Ameritech Illinois supports exclusion of access, wholesale, UNE, interconnection, and transport and termination services from the price cap mechanism on the basis that rates for these services are set through other means. However, just as access charges were subject to both price cap and interstate mirroring constraints when the price cap mechanism was adopted in 1994, the existence of additional pricing constraints does not mean that inclusion in a price cap mechanism would not be beneficial. Id. at 50. As explained by GCI witness TerKeurst, the price cap provisions could provide a convenient, low cost, and routine approach to updating the rates derived initially through cost studies, thus avoiding or deferring the lengthy and contentious proceedings to evaluate cost studies and update rates for these services, and furthering the goal of reducing regulatory costs. Id. Further, other provisions of an alternative regulation plan, notably service quality protections, are needed even if the services at issue are excluded from the price cap portion of the alternative regulation mechanism.

In addition to the more general arguments against exclusion of the four services presented above, a specific discussion of why each of these services should not be excluded can be found at pages 50 through 61 of GCI Ex. 1.0 (TerKeurst Direct). CUB urges the Commission to reject the Company's proposal to remove (1) switched and nonswitched access services, (2) UNEs, interconnection, and transport and termination services, (3) wholesale services, and (4) emergency services from any new alternative regulation plan approved in this proceeding.

7. New Service Provision

The existing Price Cap plan provides that noncompetitive services will be included in the API for the affected customer category only after the service has been offered for one year, based on twelve months of demand experienced during that period. Price Cap Order, Appendix A at 6. However, the Price Cap Order does not define the term "new service."

As discussed earlier in this Brief, the Company has taken the position that bundling of existing services creates new services, for example, the residential SimpliFive and CallPack offerings that bundle Bands A, B, and C calling.

Inexplicably, the Company has placed the noncompetitive components of its SimpliFive and CallPack offerings in the Other Basket rather than the Residential Basket, even though all residential noncompetitive usage services clearly belong in the Residential Basket.[55] AI also raised the rates of its noncompetitive residential Band A (in the case of both the SimpliFive and CallPack calling plans) and Band B usage (in the case of the SimpliFive calling plan) under those plans. GCI Ex. 1.0 at 65.

There are several concerns that arise from AI's habit of bundling existing services, relabeling them as new services, and moving them out of the assigned basket. First, by calling a bundled service a new service, AI can set the rate at whatever level it wants. Id. at 65-66. Even if the result is substantial increases over the basic unbundled rates, this does not affect the API calculation, which measures only changes from existing rates for the service. This is because the first rates from which rate changes are measured are the rates at the time the new service is first included in the price cap mechanism, regardless of whether they may be a significant increase compared to basic unbundled rates. Id. Had the noncompetitive portions of SimpliFive and CallPack plans been treated as rate changes from the existing unbundled rates, they would have fallen under the price cap provisions and, indeed, been prohibited due to the cap on basic residential rates. Id.

Second, the Company's creative inclusion of bundled usage services in the Other Basket allows it to engage in Ramsey pricing, which the price cap mechanism

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[55] The Residential Basket was established to include residence network access lines and Band A through Band C residence usage, including volume discounts, although Band C has now been reclassified as competitive. The Other Basket was established to include directory services, Chicago name and address, payphone, directory assistance, private line and operator services, residence Starline, residence Multi-ring, residence custom calling; residence advanced custom calling; and residence non-recurring charges. Price Cap Order, Appendix A at 2-3.

is intended to guard against. For example, if AI were to increase SimpliFive or CallPack rates above the initial rates at which they were included in the price cap mechanism, the Company would be able to make offsetting rate reductions to services in the Other Basket rather than having to reduce other inelastic residential services. Id. In addition, excluding bundled service offerings from the alternative regulation plan reduces the magnitude of rate reductions resulting from PCI reductions, including service quality-related reductions, should the penalty mechanism remain within the formula.

An easy fix exists for remedying this pricing inequity. In any going-forward alternative regulatory plan approved in this docket, the term "new service" should be clearly defined to exclude the bundling or any other reconfigurations of existing services. Further, the terms of the alternative regulation plan should specify that, if Ameritech Illinois bundles or otherwise reconfigures existing services to create a new offering, each noncompetitive portion of the bundled offering should be priced subject to the price cap mechanism and included in the same basket as that in which the noncompetitive service is included when offered on an unbundled basis. Id. at 67.

8. Calculation of the PCI and the API

The API, as currently applied by the Company, measures only changes in *tariffed* rates and does not capture changes in *effective* rates that may occur, for example, due to modifications to discount calling plans. The Price Cap Order did not contemplate such a situation and did not address whether the API should reflect changes in effective rates in addition to changes in tariffed rates. This loophole has been utilized by AI to raise the effective rates for noncompetitive Band A and B usage services. Specifically:

> ?? Following the competitive reclassification of residential Band C services, the Company eliminated Band C calling from the residential local usage discount program, which had provided discounts on combined Band A, Band B and Band C usage. However, the company did not adjust the usage discount bands to reflect in a revenue-neutral manner the exclusion of Band C usage from the program. Because a smaller portion of a customer's usage is now counted in determining discounts, the modified discount program increased the effective rates for noncompetitive Band A and Band B usage.[56]
>
> ?? Upon competitive reclassification of Band C and large business (businesses with 12 lines of more) Band B usage, AI removed those services from the business local usage discount plan. However, the company did not adjust the usage discount bands to reflect in a revenue neutral manner the exclusion of Band B and C usage. This increased the effective rates of the remaining noncompetitive business usage services. GCI Ex. 1.0 at 63.

This loophole should be eliminated in order to prevent the Company from generating hidden rate increases for noncompetitive services, with the proceeds passing directly to shareholders contrary to the intent of the price cap mechanism. Specifically, the Commission should state that the API formula should be applied in a manner that would measure any changes in *effective* rates that may occur as a result of modifications to discount calling plans or other factors.

AI proposes a minor change in the treatment of pricing promotions, which appears to allow the Company to not reflect temporary price promotions in the API. The purpose of including temporary price promotions in the API is to allow AI to make offsetting increases in other rates during the pricing promotion. If the Company does not wish to make those offsetting rate increases, it is reasonable to allow the company to

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[56] See, Ameritech Illinois filings and Order in ICC Docket 97-0157.

forego the administrative burden of changing the API at the beginning and end of a temporary price promotion. As a result, this AI- proposed change appears reasonable.

Finally, as discussed by GCI witness TerKeurst, the Price Cap Index ("PCI") and the Actual Price Index("API") should be reinitialized (i.e., reset from current levels to 100) as part of this alternative regulation plan review. This is an issue separate and apart from the *rate* reinitialization discussion in this docket.

The price cap mechanism requires that the API for each individual basket be no higher than the PCI. While the PCI is affected by the components in the price cap formula, including the productivity factor, the API is affected by changes to Ameritech Illinois' rates weighted by their associated demand levels. Both the PCI and the API should be reinitialized to 100 if the alternative regulation plan is extended for an additional period of time. First, any rate adjustments resulting from a review of Ameritech Illinois' earnings would reduce the API. Absent reinitialization of the API and PCI, AI could circumvent the revenue reduction by raising rates to bring the API back up to the PCI.

Second, absent reinitialization of the PCI and the API, customers purchasing services from the Carrier Basket, such as switched access services and unbundled network elements "UNEs") if included in that basket as Ms. TerKeurst recommends, would not benefit from efficiency gains experienced by the Company in the future. This is because the API for the Carrier Basket is well below the PCI due to the Commission's previous policy of mirroring interstate access charge reductions on the state level and its recent decision to price intrastate switched access charges based on their forward looking cost. Reinitializing the PCI and the API back to 100 would remove the gap between the

API and the PCI and allow customers purchasing services from the Carrier Basket to benefit from Ameritech Illinois' efficiency gains under the alternative regulation plan on a prospective basis. GCI Ex. 1.0 at 61-62.

Moreover, if AI's proposal to consolidate all of its services into a single basket is adopted, the disparity between the API and the PCI may be an issue for another reason. If AI averages the APIs of the four baskets to develop an API for the single basket, it can then raise rates of services whose original API was at or near the PCI, e.g., residential services, to compensate for the fact that other services, e.g., access services, were in a basket whose API was less than the PCI.. This would preclude residential customers from receiving benefits of Ameritech Illinois' efficiency gains under alternative regulation for the foreseeable future. Id. at 62-63.

In sum, under any plan in any form adopted as a result of this proceeding, it is critical that the Commission reinitialize the PCI and API to 100 as a starting point.

B. Relative to New Components

A discussion of most "new components" of the price cap formula itself should alternative regulation be adopted on a going-forward basis is incorporated in Part A above and in the discussion of service quality – going forward.

Other changes to the plan should be made in order to meet the statutory criteria of Section 13-506.1 of the Act, as discussed below.

1. Fixing the Incentive To Prematurely Reclassify Services and Raise Rates

The current plan, which permits excessive earnings, includes incentives to reclassify services prematurely and then raise the prices for those services, and should be modified to remove these incentives. As noted by GCI witness

TerKeurst, the refund requirements in the PUA that apply when the Commission has found that the incumbent LEC has raised rates for improperly reclassified services are not adequate, by themselves, to protect customers. One problem is that, in order for the refund provisions to be invoked whenever appropriate, the Commission must investigate every improper reclassification, an undertaking that is impractical given the broad range of services that Ameritech Illinois has classified as competitive, as indicated in the Staff Report to the Commission on AI's reclassifications, attached to Ms. TerKeurst's testimony as GCI Exhibit 1.5, the lengthy and complicated proceedings required for an investigation, and the Commission's limited resources.

Additionally, Ameritech Illinois has cited administrative problems[57] associated with paying refunds, which have resulted in prolonged delays in refund payments. GCI Ex. 1.0 at 31. Further, it is not possible to identify correctly each customer to whom a refund is owed. As a result, refunds tend to be distributed to everyone within the affected customer class, regardless of whether they actually purchased the service when it was overpriced.[58]

In order to discourage premature reclassifications, the Commission should adopt Ms. TerKeurst's recommendation that safeguards be adopted if alternative regulation is continued for Ameritech Illinois. First, the alternative regulation plan should provide for financial consequences of $10,000 per day for competitive

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[57] See, for example Ameritech Illinois Brief on Exceptions in ICC Docket 96-0069 at 14-16 citing billing system problems thereby necessitating prolonged and unspecified delays in paying out the refunds.

[58] See, for example Order in ICC Docket 96-0069 addressing the manner in which refunds would be divided among Ameritech Illinois' customer classes.

reclassifications that are later overturned by the Commission. Id. at 32. This remedy would be calculated starting the day on which the competitive classification became effective and continuing to the day on which noncompetitive reclassification becomes effective (and rates are reduced if they had been increased). This safeguard would be in addition to any refund requirements applicable pursuant to the PUA.[59] As noted by Ms. TerKeurst, compensating customers is appropriate given that they are harmed by the premature reclassification of noncompetitive services and by exposure to Ameritech Illinois' market power once the reclassified services are removed from the protections of the price cap mechanism.

Second, the manner in which AI reclassifies services as noncompetitive and provides refunds following a Commission rejection of a competitive classification should be streamlined to speed the refunds to customers. Id. at 33. AI should be required to reclassify improperly classified services back to their noncompetitive status and reduce the rates of those services back to their pre-competitive reclassification level within five days of a Commission Order rejecting a competitive classification. This could be done using the special permission tariff filing provisions rather than regular 45-day tariff filings.[60]

[59] Any amounts paid by Ameritech Illinois would be allocated among retail and wholesale customers, carriers purchasing UNEs, interconnection, and transport and termination services; and interexchange carriers based on the relative gross revenues Ameritech Illinois derives from those various customer classes. The allocated amount would be returned to retail and wholesale customers as an equal credit per network access line, and to interexchange carriers and carriers purchasing UNEs, interconnection, and transport and termination services through a percentage credit on one month's bill. GCI Ex. 1.0 at 32.

[60] Refunds, with interest, should be required to commence within fourteen days of the Commission Order. An up-front notice of these requirements to Ameritech Illinois should nip Ameritech Illinois' tendency to drag out making refunds. Such notice would also encourage Ameritech Illinois to develop contingency plans to prepare for possible refunds while a Commission investigation is underway addressing the reasonableness of a service's reclassification.

Finally, Commission adoption of an earnings sharing provision, discussed in Part III.D of this Brief, would reduce Ameritech Illinois' incentive to prematurely reclassify services as competitive and raise their rates, because Ameritech Illinois would be obligated to share those revenues with customers.

C. Accounting for Merger Savings

In the SBC/Ameritech merger order, the Commission directed that this proceeding include an analysis of how merger savings should be incorporated into the price cap formula on a going forward basis. ICC Docket No. 98-0555, Order at 149. GCI/City witness Selwyn presented a recommendation for incorporating merger savings into any approved price cap plan which should be adopted by the Commission if a new price cap formula is established in this docket.

Dr. Selwyn proposed that in order to ensure an adequate flow through of merger savings and to avoid reliance on the Company's "fuzzy math" in calculating year-to-year savings amounts, the Commission should introduce a new variable within the price cap formula similar to the productivity factor. GCI Ex. 3.0 at 39. Use of an "M" factor *on a one-time basis* would guarantee the flow-through of merger savings by further reducing the PCI and would provide the Company the incentive to achieve the savings goals it had projected. Given the fact that specific data on merger savings on only three months of 1999 are currently available, the M factor should initially be established on the basis of the level of savings that the Ameritech and SBC Boards of Directors had anticipated when the "transfer ratio" value had been set. Id.

In his testimony in the Merger docket, Dr. Selwyn calculated total merger savings at $15.4 billion, with the portion attributable to AI intrastate services at $1.86 billion. Id.

Applying the 50% ratepayer allocation of savings that the Commission adopted in the Merger case and using the annualized basis discussed above, the M factor would initially be set at 4.8%, representing the ratio of the annual net merger savings of $296 million relative to total intrastate revenues of $3.1 billion, times 50%. Id. at 39-40. It is important to note that this M factor adjustment would be a one-time modification to the formula at the outset of any new or extended price cap plan, thereby permanently reducing the PCI by the 4.8% M factor. Id. at 4.0 Dr. Selwyn noted that the objective of this proposal is to develop an estimate of productivity that is applicable in the future, not in the past.

Although a proceeding has been initiated at the Commission involving merger savings, it appears that that docket will be focused on examining the development of audit standards, as recommend by a Commission-hired audit team, along with an analysis of the savings amounts calculated for the three months of 1999. ICC Docket No. 01-0128.

CUB urges the Commission to adopt Dr. Selwyn's forward-looking, reasonable proposal to ensure that ratepayers receive 50% of the savings associated with the merger of SBC and Ameritech, as intended by this Commission when it issued its Merger Order.

D. Reinitialization of Rates/CUB/AG Complaint for Rate Reduction

Before the Commission approves any new regulatory plan, alternative or otherwise, for Ameritech Illinois, the Commission must demonstrate that the plan is in the public interest and produces "fair, just and reasonable" under Section 13-506.1(b)(1) and (2) of the Act. A plan that is not in the public interest and produces or perpetuates unjust and unreasonable rates is unlawful under Section 13-506.1(b)(1) and (2) of the Act.

Under the Company's view of its current regulatory world, its rates are just and reasonable as long as they have been set in accordance with the pricing provisions of the existing plan -- even within the context of a review proceeding. According to the Company, no adjustment to current rates is needed on a going-forward basis no matter what level of Company earnings the plan produces. AI argues that no adjustment to rates based upon a rate of return revenue requirements analysis is appropriate or relevant – even if the Commission chose to return to rate of return regulation. AI Ex. 1.1 at 96-101. AI witness Gebhardt opines that reinitializing rates based upon a revenue requirements analysis "fundamentally abrogates the regulatory bargain which Ameritech Illinois and the Commission entered into in 1994." Id. at 97.

In fact, no such regulatory bargain to permanently render earnings information irrelevant was struck between the Commission and the Company. As noted earlier in this Brief, the Price Cap Order is replete with references to the validity and relevance of earnings information – especially within the context of this review proceeding. For example, in the 1994 Order, the Commission cautioned that its decision to exclude earnings sharing from the alternative regulation plan at that time should not be construed as a rejection of earnings sharing mechanisms in the future and that it would consider inclusion of earnings sharing provisions in future review proceedings of the alternative regulation plan. Price Cap Order at 50-51. Moreover, while the 1994 plan included no set cap on profit levels, the Commission noted that "unusually high reported rates of return…may constitute a possible early warning that the total offset in the price regulation formula has been set too low or that the pricing constraints have been otherwise ineffective." Price Cap Order at 92. In addition, the Price Cap Order requires the Company to file earnings information for each preceding calendar year, including total company and jurisdictional rate base, total company and Illinois jurisdictional operating revenue and expenses, other income and deductions, preceding calendar end-of-year capital structure, total company and Illinois jurisdictional return on net utility rate base, and total Company return on common equity – in other words, all of the necessary accounting data needed to calculate the Company's earnings and revenue requirements. Price Cap Order at 93-94. The Company's position that rate of return analysis became irrelevant as of the date of the Price Cap Order is nothing more than wishful thinking.

Indeed, re-initialization is not an option but a *requirement* for the Commission's establishment of any regulatory plan for the Company. Even AI proposes that the plan in place be modified, albeit in a different direction than what GCI parties or Staff witnesses recommend. For the Commission to establish a new plan without reinitializing rates when all parties recognize that the current formula is in need of modification is an invitation to appellate reversal. Failure to reinitialize rates at the start of any new plan ensures that the going-in rates are *not* just and reasonable.

When it first established price cap regulation, the Commission specifically recognized that reinitializing rates before the start of an alternative regulatory plan was essential to the finding that rates under the plan would be "fair, just and reasonable." Specifically, a review of the Commission's analysis in the Price Cap Order of the statutory requirements for the approval of alternative regulation, and specifically the just and reasonable standard set out in 13-506.1(b)(2), underscores the necessity of reinitializing rates on a going-forward basis before any new price cap plan is adopted. The Commission noted:

> With its proposal for an alternative form of regulation, the Company provided all of the information typically submitted in a general proceeding. In addition, in response to CUB's rate reduction complaint, the Commission has evaluated whether IBT's current rates are just and reasonable. As a result of the evaluation, the Commission is directing rate changes in order to establish just and reasonable rates *and to establish an appropriate starting point for the alternative regulation plan.*
>
> *After rates are initialized,* the price index mechanism will continue to produce reasonable rates.

Price Cap Order at 186 (emphasis added). Here, the Commission recognized that no price cap formula could produce just and reasonable rates if the going-in rates were not themselves established to be just and reasonable. The Commission's language makes clear that setting rates at just and reasonable levels at the start of the plan is essential to satisfying the statutory requirement of 13-506.1(b)(2) as a part of the approval of an alternative regulatory plan.

The same analysis and conclusions apply today. As noted by Dr. Selwyn in this docket, it makes no sense for the going-in rates to be excessive at the very outset of a plan. No matter how correct the various price cap formula factors might be in any new plan approved in this docket, the rates established on a going-forward basis would likely never achieve just and reasonable status given the current excessive earnings level that the present rates produced. This is precisely the scenario that would exist if the Commission adopts alternative regulation without first re-initializing rates. City of Chicago Ex. 3.0 at 45.

A central tenet of the price cap plan was to allow AI to realize benefits from reasonable management efforts to cut costs, and to pass those benefits on to customers, in